



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Members of the Executive Committee
From: Elizabeth Harchenko, Chair, MTC Compliance Project Steering Committee
Date: July 9, 2004
Subject: State Tax Compliance Initiative Steering Committee Report and Referral of Compliance Work Group Recommendations and Reports

The MTC State Tax Compliance Initiative Work Groups have completed their work. The Steering Committee met on May 28 and June 17 to review the progress and work products of the three Work Groups. The Steering Committee has now unanimously approved their recommendations, and we now forward these to you for Executive Committee action.

The first four recommendations on sales and use taxes were previously forwarded, and were approved by the Executive Committee at its April 29 meeting. These work group recommendations, plus a new, fifth recommendation, are included here, for your information, and in the Sales and Use Tax Work Group report.

The Executive Committee will receive and act on the recommendations for corporate income tax sheltering and pass-through entity compliance at teleconferences scheduled for July 9 and 12, 2004 (3:30 pm EDT on both days). The Executive Committee must also consider how best to implement many of the recommended compliance initiatives, including the previously approved sales and use tax recommendations. Discussion of the appropriate implementation steps should constitute a major portion of the two meetings.

As part of the recommendations, the Steering Committee has suggested some implementation assignments. The Executive Committee may want to assign implementation tasks in one of three ways:

1. To an existing Standing Committee of the Commission,
2. To a special work group, which might be the work group that developed a particular recommendation, and
3. To the Executive Committee itself.

Further, the Executive Committee should decide on whether it wishes to coordinate oversight of the implementation process directly or to rely on an implementation oversight or steering committee to do so.

The three work group reports are forwarded to you with this memo. They are rich with detail on the work and findings of each work group and I urge you to share them with your staff. To use our time most efficiently during the Executive Committee discussion, I have summarized their recommendations, as approved by the Steering Committee, below. Where the recommendations offer implementation strategies, they are set off with the symbols “**” before and after such comments. An additional memorandum exploring further implementation options will be distributed before the Executive Committee teleconferences.

Corporate Income Tax Sheltering Recommendations

The following are the recommendations from the Corporate Tax Sheltering Work Group Report, pages 68-69:

1. **Combined Reporting.** States should adopt combined reporting for jointly owned and operated companies. Dividends from affiliates that are not members of the combined group should be treated as apportionable income unless the holding of stock or receipt of the income is clearly unrelated to the business of the owner. **** This reinforces the MTC Federalism at Risk recommendation on combined reporting and the MTC Uniformity Committee’s current project to develop proposed uniform combined reporting statutes and regulations. ****
2. **Expense Disallowance Statutes.** In lieu of taking the more comprehensive step of combined reporting and perhaps as an intermediate step with consideration of combined reporting as a possible future goal, separate entity states should enact expense disallowance statutes that are broadly worded to address inter-affiliate transactions that involve intangible property and also perhaps inter-affiliate loan transactions. Exceptions for some transactions may be appropriate, but exceptions to these statutes should be objective and narrow in their application as in the expense disallowance statute for intangible property that was enacted by New York State in 2003. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on expense disallowance statutes. ****
3. **Overhaul of UDITPA.** It has been almost 50 years since the drafting of UDITPA. Revisions are clearly needed in the area of sales of services and to address intangibles and the financial services sector. An alternate approach is the development of additional special industry rules through the Uniformity Process of the MTC. Rules could be developed for the sales of services; the sales of financial services businesses, such as those with brokerage or insurance activities that do not fit the current financial services rules; and other areas as needed. We recommend the first approach because this is the most direct and thorough, and could be the most effective in influencing state statutes and in taxing corporate income. **** The MTC could propose a cooperative effort with the National Conference of Commissioners on**

Uniform State Laws to overhaul UDITPA. The MTC could also solicit support from professional and private sector groups for this effort. **

4. **Adopt Throwback Rules.** To limit the occurrence of “nowhere income” states should enact throwback or throwout rules for both tangible goods and services. In addition, states should require that throwback affidavits be submitted and share this information with the states identified in affidavits. **** Guidelines for throwback rules should be included in the current MTC effort to develop proposed uniform combined reporting statutes and regulations. ****
5. **Disclosure of Filing Positions.** States should enact provisions that require disclosure of inconsistent filing positions where states have similar requirements. Failure to disclose inconsistent positions should be penalized and presumptions based on failure to disclose inconsistent filing positions should be enacted to encourage appropriate reporting by taxpayers. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on disclosure requirements. ****
6. **Tax Sheltering and Listed Transactions.** States should take advantage of the information sharing on tax shelter activity under the IRS Memorandum of Understanding and the State Memorandum of Agreement. In addition, they should adopt listed transactions legislation that includes, by reference, federal listed transactions, and provides for the definition of state listed transactions. The 2003 California legislation provides a model for the states in this area. **** This recommendation could be forwarded to an appropriate group, such as a specialized uniformity task force, or returned to the Corporate Income Tax Sheltering Work Group to provide guidelines to the states on listed transactions statutes. ****
7. **Enforce “Doing Business” Statutes.** States should clearly articulate and effectively enforce their nexus standards to ensure more complete reporting of income among the states. In applying nexus standards, states should consider thresholds, taking into consideration costs of administration and compliance.
8. **Proactive Role in Federal Legislation.** The states should take a more proactive role with respect to federal legislation, including legislation that affects state jurisdiction for corporate income taxes and federal issues, such as tax sheltering and corporate inversions, that affect both the federal and state income tax base. This should include advocacy of the MTC factor presence nexus standard and elimination of the restrictions of P.L. 86-272.
9. **Enhance Exchange of Information.** Processes should be established to implement, but not be limited to, recommendations 1-8, possibly to include a clearinghouse for sharing information among the states. This information should include current and

recent audit activity. Consideration should also be given to including tax shelter activity and other compliance issues.

Pass-through Entity Compliance Recommendations

The following are listing of recommendations from the Pass-Through Entity Compliance Work Group Report and Proposed Initiatives pages 7 through 9. Please see pages 7 through 9 of the full report for further details on each of these items.

A. Publicize and Encourage States to Adopt the MTC's Uniformity Proposal for Reporting Options for Nonresident Members of Pass-Through Entities.

Withholding of tax on distributed income by the payor of that income remains the primary method to ensure that income of owners from pass-through entities is reported and the tax paid. This is the same primary compliance method that the federal government and the states use for most other forms of income. The Commission has already developed a Uniformity Proposal that provides for withholding on income distributed to nonresident members, where compliance is most problematic. Withholding is imposed, however, only as backup if the entity does not choose to avail itself of the convenience of a composite return reporting and paying tax for nonresident members.

Many states have already adopted various forms of withholding. Most common, and most favored by taxpayers, is withholding only if the taxpayer refuses to file a promise to pay. The Commission felt that while a promise is good, actually getting the tax paid when the income is distributed is vastly better.

**** The remaining effort here, then, is to publicize the MTC proposal and work with states to encourage their adoption of it. ****

B. Work with California, New York and Pennsylvania as Lead States in Developing a Common Database or Data Warehouse on Flow of Income from Pass-Through Entities to Owners.

As indicated by the wide range of the original MTC estimate of revenue loss due to non-compliance by owners of pass-through entities (between \$1 billion and \$12 billion), the largest problem here is simply not knowing what income is earned and where it is going. The complexity of the ownership tree can be enormous. A given pass-through entity can be owned by other pass-through entities, which are, in turn, owned by others, and so on ad infinitum. Into the mix can be added ownership by C Corporations, by trusts, by individuals, both foreign and domestic. Tracing where the income goes can become an impossible task.

Certain lead states have been developing data warehouses and databases that will allow the tracking of the ownership interests of pass-through entities. **** The work group believes that one of the best compliance tools for the states would be to work with**

these lead states to enhance these databases and obtain the use of the databases, possibly through a fee for service arrangement. The New York Multi-State Tax Shelter Application program that states may utilize by entering into a Memorandum of Agreement may already be on the way to provide the desired capabilities. **

C. Develop Educational Resources on Pass-Through Entities for the States

The greatest concerns of the states expressed in the survey all centered on the lack of information—information about the character of pass-through entities, about the extent of their activities, about their owners, and about the interrelationships among entities with multiple ownership levels. Ms. Brenda Gilmer (MT) has begun the task of bringing together in one document a collection of references to information about all aspects of pass-through entities. The document provides jump cites to various Internet websites wherein information can be found. The work group applauds this Herculean effort by Ms. Gilmer and recommends that this document continue to be refined for eventual placement on the MTC secure Extranet website to be available to the staffs of member states.

To supplement the educational compendium, the work group recommends the development of training sessions for state auditors on how to recognize pass-through entity issues as well as a more specific training component on sophisticated methods of attacking the latest pass-through entity sheltering techniques

**** To implement this recommendation there will need to be a continuing group to maintain the educational compendium on the website and to develop and run training programs. ****

D. Create an Ongoing Liaison Group to Work with the Internal Revenue Service to Coordinate Compliance Efforts on Proper Reporting of Pass-Through Entity Income

The conferences with the IRS have confirmed that the IRS is ahead of most of the states on many of its compliance systems for pass through entities. Even the most basic step, the matching of income reported by entities on Schedule K-1s to the income reported by the owners on their returns would be an enormous help to the states. MTC Executive Director Dan Bucks recently met with IRS Commissioner Everson and had a very productive discussion on how the states and the IRS could work together. **** The work group strongly recommends that the Commission and the states create a liaison group to continue to forge alliances with the IRS for mutual compliance assistance with specific reference to pass-through entities. ****

Sales and Use Tax Recommendations

The Executive Committee has previously acted on the first four of the following recommendations, and the fifth has been referred to the Resolutions Committee. Thus,

they are listed here only in summary form. For further details, please see pages 8-11 of the Sales and Use Tax Compliance Work Group Report.

1. Develop a Template for Informational Mass-Mailings to CPA's and Tax Practitioners. **** The initiative could be assigned back to the Sales & Use Tax Compliance Work Group for implementation. ****
2. Promote Awareness of the Existing MTC Voluntary Disclosure Program. **** The Work Group recommended this initiative be forwarded to an appropriate MTC standing committee for implementation. ****
3. Develop an MTC Proposed Uniform Affiliate Nexus Statute or Regulation. **** The Work Group recommended this initiative be forwarded to the MTC Uniformity Committee for further development and implementation. ****
4. Enhance Exchange of Information to Improve Identification of Non-Filing Companies that have Sales and Use Tax Nexus. **** The Work Group recommended this initiative be forwarded to an appropriate MTC standing committee for further development and implementation. ****
5. Review and Reissue Multistate Tax Commission Policy Statement 2002-01, titled Improving State Sales Taxes to Achieve Fairness and Simplicity.